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# United States
# Circuit Court of Appeals
## For the Ninth Circuit

West Coast Life Insurance Company, a corporation, Pacific National Bank of San Francisco, a national banking association, et al.,
*Appellants,*

vs.

Merced Irrigation District,
*Appellee.*

# PETITION FOR REHEARING


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We respectfully petition this Court for a rehearing of this appeal upon the following grounds:

### INTRODUCTION

The only points here discussed are those which, we believe, particularly require discussion in light of the Court's opinion, although we urge the Court to reconsider the other points which we have heretofore advanced.

# I.

## AFFIRMANCE OF THE DECREE SHOULD IN ANY EVENT BE ON CONDITION OF PAYMENT TO OBJECTING BONDHOLDERS OF 4% INTEREST

We made three arguments in support of the proposition that the plan is unfair because the objecting bondholders get only the principal amount offered by the plan without any interest whatever.

The Court has considered two of our three arguments, namely, (1) that the plan is discriminatory between consenting and non-consenting bondholders because the former were paid a total of $168,000 in interest (R. 368), and (2) the argument that the plan is unfair because the RFC has received 4% interest from the time of its disbursement, i. e., from October 4, 1935 (R. 344), namely, a total of 20% up to October 4, 1940.

The Court does not mention, however, our principal argument in connection with denial of interest to objecting bondholders, namely, this: As was stated at the oral argument:

> "In this case the bondholders were told, 'If you have the temerity to question our plan, you must forego any income on your money for such time as it takes to litigate.' * * * The bondholders here were confronted by an agency of the State of California and an agency of the Federal Government, which looked the bondholder in the eye and said, 'Here is what we offer you. Now, what are you going to do about it?'

> "The penalty for questioning their proposal was loss of income for such time as it might take to litigate it, plus $9.18 per bond."

And as was said in the main brief for appellants (p. 61):

> "No compensation is allowed by the plan to appellants for the period they have waited, although during most of this time there was no statute in effect under which this district could have compelled acceptance of its plan.
>
> "In the case of *In re James Irrigation District,* 25 Fed. Supp. 974 at 975, it was held that interest paid to consenting creditors should also be paid to non-consenting creditors.
>
> "Appellants should not be penalized for resisting the prior proceeding, which was determined to be void as they contended. Delayed payment is vitally different from prompt payment:
>
> "*State v. City of New Orleans,* 102 U. S. 203.
>
> "The plan in that case was approved subject to such provision being made."

We earnestly submit that denial of any interest to objecting bondholders makes the plan unfair; and if confirmation of the plan is to stand, the decree should make the confirmation conditional upon payment to objecting bondholders of 4% interest from the time of the first disbursement to consenting bondholders. This for the following reasons:

(1) In the first place, there is no question but what a bankruptcy court, as a court of equity, has

power to impose conditions, on equitable principles, so long as those principles are not inconsistent with the Bankruptcy Act.

The principle that an equitable decree must not be unfair is not only a fundamental principle of equity but an express command of this statute. As was said in

> *Securities & Exchange Commission v. U. S. Realty & Improvement Company,* ........... U. S. ...........; 60 S. Ct. Rep. 1044, 1053-4:

> "A bankruptcy court is a court of equity, §2, 11 U. S. C. A. § 11, and is guided by equitable doctrines and principles except in so far as they are inconsistent with the Act. [Authorities.] A court of equity may in its discretion in the exercise of the jurisdiction committed to it grant or deny relief upon performance of a condition * * * we cannot assume that Congress has disregarded well settled principles of equity, the more so when Congress itself has provided that the relief to be given shall be 'fair and equitable and feasible.' Good sense and legal tradition alike enjoin that an enactment of Congress dealing with bankruptcy should be read in harmony with the existing system of equity jurisprudence of which it is a part."

This being true, this Court's power to grant the relief on conditions which will make its operation fair and equitable is not only within its power, but a part of its duty.

(2) Secondly, and apart from the foregoing, we submit that the Act should not be construed as author-

izing a plan (as here) whereby the bondholders' unquestioned right to object to the plan, and to ask for judicial examination of its fairness, is seriously handicapped and penalized by the plan itself. This plan tells the bondholder that he must accept the amount offered in full satisfaction of an undisputed debt, or else forego the enjoyment thereof for such number of years as it will take to litigate it, receiving no interest whatsoever in the meantime. Such a plan is contrary, we submit, to the purposes of the statute, which certainly was not intended to permit petitioning districts to subject their bondholders to substantial coercion in order to compel acceptance of plans believed by the bondholders to be unfair. See:

> *Manning v. Brandon Corporation,* 163 So. Car. 178, 161 S. E. 405.

(3) It is important to observe that payment of interest to the objecting bondholders *will not require the District to make any payment whatever beyond what the plan itself contemplated.* The central theory of the plan is that the District proposes to borrow money at 4% wherewith to discharge its bonds at 51.501¢ on the dollar. The actual operation of the plan under the decree of the Court is that the District saves 4% for five years on the entire amount admittedly owing to the objecting bondholders (by the very terms of the plan) from the beginning; and they in turn are penalized in an equal amount by being deprived of both the use of their money and interest thereon during the entire period of litigation.

Surely the District should not thus profit, nor should the objecting bondholders thus suffer as compared with consenting bondholders, solely because they objected to the plan on the ground that they believed it to be unfair.

(4) The most obvious analogy to the present situation in private law is the effect of a tender as stopping interest. It is Hornbook law that a conditional tender does not stop the running of interest.

6 *Williston on Contracts* (Rev. Ed.) 5144.

More particularly, a tender on condition that the creditor surrender a right then in litigation between the parties is no tender at all, and is ineffective, therefore, to stop the running of interest.

*Cameron County Improvement Dist. No. 8 v. De la Vergne,* 100 F. (2d) 523.

So here, the plan was in substance a tender to the bondholders of much less than half the amount owing to them (taking account of unpaid interest), made on condition that the amount tendered be accepted in full satisfaction of the debt. Whether or not the bondholders were bound to accept the amount tendered as full satisfaction (i. e., whether or not the plan was "fair") was, as a matter of law, a question which the bondholders could with entire justice and propriety dispute.

For the foregoing reasons we submit that to say that the offer of the plan stopped the running of the interest on the amount ultimately found owing is contrary to the reasonable construction of the statute, is eminently unfair and inequitable, and is contrary to analogous rules of law.

We earnestly submit, therefore, that if the plan is to be confirmed, this Court's decree should in any event impose, as a condition to affirmance, that the objecting bondholders be paid interest at 4% from the date of the original disbursement by the RFC (October 4, 1935, R. 344) to the date of actual payment.

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## II.

### RES JUDICATA

This Court seems to announce two principal propositions concerning the plea of *res judicata*:

1. The Court seems to say (pp. 8-9) that the record does not establish the fact that this Court held, in the prior action between these parties, that the first Municipal Bankruptcy Act was beyond the power of Congress to enact.

2. The Court seems to say (pp. 6-8, 9-11, 46-8) that the prior adjudication between these parties that the first Municipal Bankruptcy Act was void, is not *res judicata* of the proposition that the present Municipal Bankruptcy Act is void, because the two Acts are distinguishable.

It is, we submit, clear that the Supreme Court of the United States in *Ashton v. Cameron County Improvement District Number One,* 298 U. S. 513, placed its decision that the first Municipal Bankruptcy Act was beyond the powers of Congress to enact on the ground that the bankruptcy clause of the Constitution does not confer power upon the Congress to scale down the debts of public corporations such as improvement districts and irrigation districts. The Court's language is unequivocal:

> "We need not consider this Act in detail or undertake definitely to classify it. The evident intent was to authorize a federal court to require objecting creditors to accept an offer by a public corporation to compromise, scale down, or repudiate its indebtedness without the surrender of any property whatsoever. * * *
>
> "Our special concern is with the existence of the power claimed—not merely the immediate outcome of what has already been attempted. * * *
>
> "The especial purpose of all bankruptcy legislation is to interfere with the relations between the parties concerned—to change, modify or impair the obligation of their contracts. The statute before us expresses this design in plain terms. It undertakes to extend the supposed power of the Federal Government incident to bankruptcy over any embarrassed district which may apply to the Court. * * *"

Upon this ground the Court held the statute void. Not, that is to say, upon the ground of any of its particular provisions, but upon the ground of its ultimate purpose (identical with the purpose of the present statute), namely (in the language of the Court):

> "to authorize a federal court to require objecting creditors to accept an offer by a public corporation to compromise, scale down, or repudiate its indebtedness without the surrender of any property whatsoever."

The ultimate proposition at law, therefore, upon which the decision of the *Ashton* case rested, was the proposition that the Congress cannot scale down the debts of such corporations as that here involved.

If this is true, it certainly cannot be said that slight difference of detail between the two statutes has any effect on the situation. The rule of law announced and applied in the *Ashton* case, if applied in the present case, calls for the conclusion that the second statute is void. Since the rule of law announced in the *Ashton* case is *res judicata* between these parties, it follows that this proceeding, which cannot lie unless the Congress has power to scale down the debts of the petitioner, should be dismissed.

We turn now to the other proposition which this Court seems to announce, namely, that it does not appear that it held the first Act to be beyond the powers of Congress, in the previous suit between these parties.

We respectfully submit that no one can doubt the ground of this Court's decision in the prior suit between these parties reversing the judgment of the trial court and directing dismissal of the proceeding. One ground and one only was urged upon the Court, namely, that the proceeding would not lie unless the statute upon which it rested was a valid enactment, and that the Supreme Court had held that statute to be void. (R. 333-337) This Court said that upon consideration of the motion, the judgment should be reversed with directions to dismiss. (R. 338) This Court knows, judicially and in fact, that it granted the motion because it felt bound by the reasoning and decision of the United States Supreme Court in the *Ashton* case. It follows that the ground upon which the first proceeding between these parties was dismissed was the ground upon which the Supreme Court of the United States decided the *Ashton* case.

We submit that it is unfair to appellants for the Court to cast doubt upon the reason for its first decision.

**Blair v. Commissioner, 300 U. S. 5.**

Both the majority and concurring opinions rely on *Blair v. Commissioner,* as establishing a rule whereby the first decision between these parties is not *res judicata* of the power of Congress to scale down the debts of the Merced Irrigation District.

The Court's analysis of the *Blair* case, if accepted, simply abolishes the rule of *res judicata* in all cases where a decision between other parties establishes a rule of law different from the rule of an earlier case which would otherwise be *res judicata.*

The intervention of the second Bankruptcy Act is plainly not relevant because no such statute was involved in the *Blair* case, and the *Tait* case which the Court there distinguished did involve an intervening statute, as have many other cases which certainly are not overruled by *Blair v. Commissioner.*

The fact is, we submit, that the decision of *Blair v. Commissioner* deals with a very special situation, namely, the situation where a federal court, having announced its views concerning what the State law is in an earlier decision, finds, in a later case on a different cause of action between the same parties, either that it was mistaken or that the State law has changed.

The vital point is that the federal courts cannot finally declare the law of a State. A State court decision, contradicting an earlier federal decision as to what the State law is, must be accepted and applied in later cases in the federal courts.

In the present case, however, a very different situation is presented. In the *Ashton* case, the Supreme Court of the United States construed the Constitution, and determined that the Congress had no power to enact a statute providing for an enforced scaling down of the debts of irrigation and similar districts. Thereafter, in the *Merced* case, this Court accepted (as it was bound to), and applied that rule of law between these parties; and thereafter the Supreme Court of the United States made that decision final by denying certiorari. Later, the Supreme Court held in litigation between other parties that Congress does have power to do what had been attempted in the first case, thereby creating a typical situation wherein the rule of *res judicata* becomes an operative factor. This Court's decision herein amounts to the proposition that since the time of the first decision between these parties, the Constitution of the United States has been amended. If it had been, then the *Blair* case would be precisely in point; but no such amendment exists in fact.

Until it is held that decisions of the Supreme Court on constitutional questions amount to amendments of the Constitution, and not merely to judicial decisions of controversies between particular litigants, it will not be true that litigants must re-litigate rights governed by rules of constitutional law whenever the Supreme Court has changed, or appears likely to change, its views.

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## III.

### FAIRNESS OF THE PLAN

Several considerations must be mentioned:

(1) The beginning of the Court's discussion of fairness seems to assume that the plan is fair unless the District could pay its debts in full. The fact is, of course, that the plan is not fair if the District could reasonably pay substantially more than it offers.

The remaining comments on the Court's treatment of fairness can be conveniently stated in the form of contrasts between the Court's opinion in this case and its opinion in the case of *Fano v. Newport Heights Irrigation District, No. 9147,* decided the same day.

(2) In the *Fano* case, this Court emphasizes and gives much weight to the fact that the District there

involved, although unable to meet its debts as they mature, owned "assets in value many times the indebtedness". (Opinion p. 5) In the *Merced* case, we have pointed out at length the indisputable fact that the District's assets far exceed its liabilities. The Court does not mention the matter.

(3) In the *Fano* case, this Court makes much of the fact that the percentage of delinquency in payment of assessments for certain years was small, and accepts this circumstance as strong evidence that the District could have levied larger assessments, and therefore could have paid more than the amount of the assessments actually levied would indicate. In the *Merced* case, we have shown at length that during the entire 18 years of the Merced Irrigation District's existence the landowners have actually paid in assessments an average of $700,421 a year; and that this amount is sufficient to amortize and discharge bonds (bearing interest and with maturities like those offered by the plan) having a total capital sum of from $4,800,000 to $8,400,000 more than the plan offers. Payment of assessments in the future equal to the average assessments actually paid in the past (during a period of unprecedented depression) will amortize a bond issue of $4,800,000 more than the plan offers, even if we accept the District's indefensibly high figure of $500,000 per year for operating expenses and also accept the District's indefensibly low figure of $445,000 per year power revenue. It follows that taking the assessments actually and admittedly paid in the past, and taking the District's own contentions as to its expenses and its other revenues, the

plan is grossly unfair under the reasoning of this Court in the *Fano* case. The Court does not mention our discussion of this aspect of the case. (See the summary of our argument on this point in the printed oral argument of appellants, pages 11-18.)

(4) In the *Fano* case, this Court condemned the District for relying on large capital expenditures as a basis for its contention that its ability to pay was small. In the present case, we have shown that the Merced District has in the past, indeed since its first permanent default, made enormous expenditures by way of capital betterments; and that in computing its operating expenses for the future, it represents and contends that it may count as operating expenses (to be paid before its debts are paid), capital expenditures of $125,000 per year, which amount is nearly one-half of its actual operating expenses. (See the summary of our argument on this point in the printed oral argument, page 14, ff.) The Court does not mention our discussion of this question.

In the *Fano* case, this Court adopts in effect the principles announced in *Case v. Los Angeles Lumber Products Co.,* 308 U. S. 106, as applicable in proceedings under the Municipal Bankruptcy sections. This, of course, is, we contend, quite correct. In the *Merced* case, however, this Court wholly ignores and in substance repudiates the doctrines there announced, namely, that:

(a) A debtor whose assets exceed its liabilities may not scale down its debts against unsecured creditors, to say nothing of secured creditors;

(b) A debtor cannot submit a plan as fair which rests upon the proposition that no plan at all would have been worse. In the *Merced* case the Court in substance holds the precise contrary in the part of its opinion wherein it traces the history of the District and quotes the trial court's opinion, both emphasizing and relying on the argument that if no plan had been adopted the District would probably have been unable to pay as much as it now offers. (Opinion, pp. 44-46)

(5) We have devoted much time in the past to the District's power revenue, and have demonstrated, we believed, that the District's power revenue alone, without the levy of any assessments whatever, will pay off completely the refunding bond issue proposed in this proceeding, and that after those bonds have been paid the District will (having accumulated a capital depreciation fund) have in effect a new power plant, paid for with the bondholders' money, and will thereafter be able to operate without any assessments whatsoever, even for operating expenses. This Court's only mention of power revenue is contained in its treatment of insolvency where the Court states:

> "The claimed fact that power revenues, etc. of the District will be sufficient to meet the obligations after they have been scaled down as proposed by the plan, does not have any bearing on the question of insolvency of the District."

Assuming that the proposition just quoted is correct, it wholly ignores, as does the Court's opinion as a whole, the vital importance of power revenue as bearing on the District's ability to pay, i.e., as bearing on the question whether the plan is fair.

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## IV.

### CLASSIFICATION OF CLAIMS

The Court ignores the fact that the RFC is a secured creditor, and that under the provisions of the Bankruptcy Act, Section 83(b):

> "The holders of claims for the payment of which specific property or revenues are pledged, or which are otherwise given preference as provided by law, shall accordingly constitute *a separate class or classes of creditors.*"

The RFC contract provides that the RFC shall not be obligated to make the loan

> "unless the Borrower shall provide for the allocation of funds and income derived from the sale of electrical power by the Borrower to the payment of the loan authorized by this Resolution in an amount and manner satisfactory to the Division Chief and Counsel." (Ex. 00, pp. 177-8)

And the final refunding bond purchase contract (Ex. 00, p. 202) provides for the allocation of power revenue to the maintenance of a reserve fund, and to the ultimate payment of the refunding bonds. (Ex. 00, pp. 208-210) This reserve fund now contains over $1,-000,000. (R. 669)

No amount of refined logic can obscure the fact that the debt owing to the RFC, whatever its amount and however it be evidenced, is secured by a very large amount, and has been so secured ever since it became a creditor in any imaginable sense. And under the inescapably plain language of the statute, such a creditor (even assuming it is otherwise in the same class with us), must be classified in a different class from creditors who, like the objecting bondholders, are not similarly secured.

In short the RFC has, in this particular case, voluntarily contracted itself into a different class of creditors from the objecting bondholders.

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## V.

### GOOD FAITH OF THE DISTRICT

We shall not discuss this point at length. We respectfully submit, however, that even assuming with the Court that the District misappropriated only \$320,000 instead of \$717,000, as we contend, that fact, and the fact that the part of this sum to which the dissenting bondholders are entitled is "comparatively small" cannot gloss over the gross fact that the District misappropriated nearly one-third of a million dollars which, as the Court assumes, was "in the face of the bondholders' rights."

The Court characterizes several items of misrepresentation in the statements, submitted to the Court by the District to show that it needed relief, as mere "bookkeeping items." Most fraudulent misrepresentations of financial condition are.

The Court seems to admit (at any rate it assumes) that in stating its total net worth, the District set up nearly a million dollars as operating expenses which should have been set up as capital assets. The effect indisputably was that the District's total net worth was represented to the Court by the District as nearly one million dollars less than it is in fact. We submit that the Court's treatment of this item does not dispose of the fact that this was a gross misrepresentation of the true condition of the District, put forward by the District as demonstrating that the plan was fair.

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## VI.

### IS RECONSTRUCTION FINANCE CORPORATION A CREDITOR AFFECTED BY THE PLAN?

We point out the following:

(1) In discussing this question the Court ignores a vital provision in the contract between the RFC and the District. Immediately after the provision, which the Court deems important, whereby the RFC reserves the right "to enforce * * * full payment of principal and interest of such Old Securities", *and in the same sentence,* appears the following (Ex. OO, p. 165):

> "if the Borrower shall, before any New Bonds are delivered to this Corporation, pay or cause

> to be paid to this Corporation an amount equal to the disbursements it has made to or for the benefit of the Borrower with 4% interest thereon until paid, this Corporation will thereupon surrender or cause to be surrendered the Old Securities then held by it or on its behalf to the Borrower."

To say that the RFC is the absolute owner of the bonds which it is thus bound to surrender upon receiving 50 per cent of their face value, or to say that it is affected just as we are, by the plan which gives it precisely the same amount as it is bound in any event to accept, is, we submit, not reasonable.

Three conclusions follow: (a) The District does not owe the full amount of the bonds, (b) the RFC is in a class of creditors distinct from the class of which objecting bondholders are members, and (c) RFC is not a creditor affected by the plan.

(2) The Court ignores the many cases cited in the separate brief of Florence Moore, et al., (pp. 29-32) and in appellant's reply brief, (pp. 13-17) which show, we submit, that the provisions of the statute upon which the Court relies should not be construed as making the RFC a creditor for the full amount of the bonds.

(3) The Court seems wholly to ignore our analysis of *Luerhmann v. Drainage Dist. No. 7,* 104 F. (2d), 696, which shows, we submit, that the *Luerhmann* case has no bearing here. (Appellant's Reply Brief, pp. 23-25)

(4) In reply to our argument that subdivision (j) of Section 403 of the Act is not applicable here because not intended to operate retrospectively, this Court says that our argument is "premised upon the assumption that the Old Bonds were extinguished before the section was enacted." Such was not our argument. Preliminarily the Court's invocation of subdivision (j) assumes that but for that provision the RFC's rights under its contract would be those of a pledgee, limited to the amount of its loan. This because unless the Court's argument so assumes there is no purpose in invoking subdivision (j). To apply subdivision (j) here would be to make it say in substance that whereas the RFC took over bonds some years before the enactment of this statute, and whereas by the contract the RFC's rights in the bonds were those of a pledgee to secure a debt of approximately one-half the face value thereof, it is hereby enacted that the debt thus created is doubled (as against other creditors), and the RFC's rights as a pledgee are, as against them, converted into those of an absolute owner.

(5) The Court ignores the simple fact that subdivision (j) above discussed, upon which the Court relies as entitling the RFC to consent to the plan, was not enacted until after this proceeding had been commenced and could not, therefore, possibly support the purported consent of the RFC.

(6) The Court ignores the fact that the provisions of the statute upon which it relies as validating the

consent of the RFC do not suggest that they were intended to enact that the debtor is to be deemed to owe the entire face value of the bonds held by the RFC *in determining whether or not the District is insolvent, or in determining whether or not the plan is fair.*

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## CONCLUSION

We submit that the considerations above discussed, together with the considerations heretofore urged by appellants re-examined in the light of the foregoing, call for a rehearing of this appeal, and for reversal of the judgment of the Court below with directions to dismiss the proceeding.

Respectfully submitted,

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San Francisco, October 3, 1940.

## Certificate of Counsel

We hereby certify that in our judgment the foregoing Petition for Rehearing is well founded and that it is not interposed for delay.

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*Attorneys for Appellants, Florence Moore; American Trust Company, as trustee under a certain agreement between R. S. Moore and American Trust Company dated December 15, 1927; Crocker First National Bank, as trustee under a certain agreement between Florence Moore and Crocker First Federal Trust Company, dated December 15, 1937.*

San Francisco, October 3, 1940.